

Krugman's Liquidity trap claptrap

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Free market capitalism is the best system of economic organisation ever devised. The 20th century demonstrated that it is consistent with both material prosperity and personal freedom. However, the Great Depression and the more recent Great Recession were major setbacks, which suggested that contemporary capitalism might be vulnerable to macro-economic instability.

Critics of the free market often focus on alleged inadequacies of the financial system, not least because it is this system that is distinctively capitalist. A common allegation is that banking is particularly unsatisfactory and needs far-reaching reform of some kind or other. Related arguments are that banks' principal liabilities, the deposits that nowadays constitute the bulk of the quantity of money, have a potentially troublesome relationship with people's asset portfolios and expenditure behaviour.

A particularly complex argument of this sort was presented by Keynes in his 1936 *General Theory*. His quarrel was with the quantity theory of money and, more specifically, with Ralph Hawtrey, who in the 1930s was in effect the Treasury's chief economic adviser. Hawtrey was a strong believer in a monetary theory of the trade cycle. He therefore claimed that increases in the quantity of money, which the state could engineer by means of open market operations, were a sufficient answer to the high unemployment then prevailing. He opposed the public works, and the wider deployment of fiscal policy, which Keynes supported.

Keynes argued that investors balance money and fixed-interest bonds in their portfolios, and that in certain circumstances this balancing could have perverse results for the wider economy. Suppose that the economy has passed through a recession, so that the price level is flat or falling, and bond yields (which Keynes called "the rate of interest") are exceptionally low. Investors fear that the next move in bond yields may be upwards, which would give them a capital loss.

As a result, if the government or central bank were to inject extra money into the economy, investors would not buy bonds at a higher price (which ought to push down "the rate of interest"), but instead let the ratio of money to their wealth rise without limit. In the jargon, "the interest elasticity of the demand for money would be infinite". So, open market operations would be unavailing and Hawtrey's reliance on monetary policy alone would have disappointing results. In 1940 Dennis Robertson, one of Keynes' intellectual antagonists, invented the sobriquet "the liquidity trap" to describe this unfortunate state of affairs.

The catchy phrase has subsequently appeared countless times in textbooks. However, few people now read *The General Theory* with the care and attention that it demands, and the original meaning of the liquidity trap has been diluted almost to vanishing point. The phrase has come to be applied to any situation in which, in some sense or other, "monetary policy does not work". For example, Paul Krugman, has asserted in several articles in his *New York Times* column – as on 14th December last year – that the world's leading economies are in "a classic liquidity trap".

According to that column, a classic liquidity trap occurs when "a zero short-term interest rate isn't low enough to restore full employment". Krugman – who won the Nobel economics prize in 2008 – is widely regarded as the USA's most articulate and effective spokesman for Keynesian ideas. For those uninitiated in macro-economic theory his words are taken as gospel. However, the trap called "classic" by Krugman is no such thing.

Krugman talks about the “short-term interest rate”, by which he means the interest rate set by the central bank. Yet, Keynes’ trap arises when increases in the *quantity of money* cannot push *nominal bond yields* beneath a certain level (which must be *above zero*) because investors have perverse expectations about *the price of bonds*. Krugman’s trap holds when the central bank cannot, by increasing *the monetary base*, cut the *short-term interest rate* beneath zero. That leads to an unacceptably high *real* interest rate if people are concerned about falling prices. Krugman’s trap is not at all a classic trap originating in the debates of the 1930s. It is an entirely new trap that he has invented. Keynes’ trap is implausible and certainly does not exist today.

Modern Keynesians are untrustworthy, if they can so wilfully misunderstand and misrepresent their supposed intellectual hero. The supposed “liquidity trap” is a plaything of left-wing intellectuals, not an argument for the subversion of a hugely successful capitalist economic system. In the form suggested by Keynes the liquidity trap does not exist today. In the form suggested by Krugman, his so-called liquidity trap does not invalidate monetary policy because monetary policy can still be effective using instruments other than short-term interest rates.